

Management Discussion and Analysis

DIVIDEND

The Board of Directors recommends a payment of a final dividend of HK2.0 cents per share for the year ended 31 December 2006. As no interim dividend was declared, the total dividend for the year ended 31 December 2006 is HK2.0 cents per share. Subject to the approval of the shareholders at the forthcoming Annual General Meeting to be held on 5 June 2007, the final dividend will be distributed on or about 11 June 2007 to shareholders whose names appear on the Register of Members of the Company as at the close of business on 4 June 2007.

CLOSURE OF THE REGISTER OF MEMBERS

The Register of Members of the Company will be closed from 29 May 2007 to 4 June 2007, both days inclusive, during which period no transfer of shares will be registered. In order to qualify for the final dividend and attending the forthcoming Annual General Meeting, all transfers of shares accompanied by the relevant share certificates and transfer forms must be lodged with the Company's Branch Registrar and Registration Office in Hong Kong, Tengis Limited, at 26th Floor, Tesbury Centre, 28 Queen's Road East, Wanchai, Hong Kong before 4:00p.m. on 28 May 2007.

FINANCIAL REVIEW

In spite of a competitive market, Chitaly, as a branded furniture provider, has managed to retain its leading position and tap all opportunities to expand its market share. Turnover increased from HK\$413 million last year to HK\$489 million this year. Net profit decreased from HK\$78 million to HK\$23 million. The drop in profit was mainly due to the soaring costs of raw materials which made the gross profit margin decreased from 34% to 26%. The Group's retail sales for the year were up to HK\$80 million, representing an increase of 82% and has a gross margin of 52%. The gross margin of wholesales to franchisees decreased to 21% (2005: 34.2%). This was a result of the increase in raw material prices and manufacturing costs. Net profit was HK\$23 million (2005: HK\$78 million). The drop in profit was mainly attributable to several factors: the decrease in gross margin of wholesales, the increase in promotion and advertising costs by approximately HK\$8 million and retail outlets boosted selling and distribution expenses by about HK\$15 million. Having incurred increased selling and distribution expenses, the retail operation recorded a net loss of about HK\$1.4 million.

BUSINESS REVIEW

Continuous Brand Building Strategies

Our brand "Royal Furniture" is one of our important assets and also one of our keys to the success of Chitaly. We have seen how powerful our brand is, especially in the highly competitive market of 2006. Our commitment to maintaining and refreshing our brand is beyond doubt. By appointing a "Ms. Rosmund Kwan", a Hong Kong Movie Star, as our product advocate for the past few years, we have succeeded in demonstrating to our consumers that "Royal Furniture" is a trendy and stylish brand. In 2006, constant media promotion activities such as printed media, billboards and television advertising were expensed to maintain brand awareness in China. Besides, the Royal flagship store in Beijing further symbolized our leading position in the medium to high end furniture industry. The 30,000 square-foot, 5-storey flagship store showcases the major series of the Group's modern romantic furniture and over a thousand pieces of branded products.

Network Extension

In 2006, the Group has over 1,000 franchise outlets widely spread in different part of China. We believe that our franchise network is of the greatest penetration in the furniture industry in China. Besides, over 20 owned outlets were well distributed in Beijing, Shanghai and Shenzhen in 2006. 2006 is the second year that the Group runs its own outlets. Without taking the costs of operating the Beijing flagship store into account, our retailing business has made a profit of HK\$1.9 million this year. The Group also had its franchise system taken root in Indonesia, the Philippines and the United Arab Emirates, as well as the signing of a licensing agreement with a distributor in Spain.

Product Expansion

As in 2005, the Group carried through its strategy of wide product range. In 2006, the Group marketed eight series of home furniture, namely "Light Walnut", "New Black Walnut", "Glossy", "Sabili", "New focus", "City Living", "Simplified" and "Ebony". The eight series of home furniture target on different strata of the market and minimize the fashion risk of the Group.

Design Capacity

The Group devoted itself to offering unique and innovative designs and superior quality products to its customers. The Group further enhanced its research and development department through injecting more resources and implementing personnel restructure in 2006. The Group merged the two research and development departments which originally located in Guangzhou and Dongguan factories into one department and settled it in Guangzhou head office, led by a designer from Hong Kong stationed in China. Also, more financial resources had been put into the department as well. The research and development expenses increased by 80% as compared with 2005.

Investment in Production Facility

In order to meet the increasing demand of consumers, the Group started to expand its production facility by construction of a new production plant in Guangzhou in 2005. By the end of 2006, the construction was nearly completed. The production capacity would be increased substantially. Such increment in production capacity is able to meet the 2007 production schedules and the order to be placed by Beijing Organizing Committee for the Games of the XXIX Olympiad.

Other Revenues

Except providing wooden furniture, the consumers can also purchase other kind of furniture such as mattress and sofa for the Group's franchise outlets. The Group sources or OEM other non-wooden furniture from outside supplies and then supplies it to our customers under the brand name of Royal Furniture. This sourcing business enriches product mix provided to its franchise furniture outlets and further reflects the value of its brand name. During the year, the other income revenue from this service decreased by 6%, which was mainly due to the increase in purchase cost from outsider suppliers.

Management Discussion and Analysis

PROSPECTS

The furniture market in China is competitive due to its low entry barrier. Many industry players were unable to survive last year. However, nowadays, as the living standard of Chinese people is improving, we believe the competition is not solely on price but also on the reputation of the brand, the design and the quality of products. Facing the hike in raw materials prices, we will keep abreast of the market and if possible, further transfer certain cost pressure to the end user. Internal administrative restructuring will be implemented to keep the administrative expenses at current level. Also, we are now preparing the supply of home furniture to Olympic Games 2008. Our new production site is nearly completed and ready to undertake the orders. Serving the Beijing 2008 Olympic Games will further reinforce the image of our brand "Royal Furniture", and the effect of which will grow as we are approaching year 2008 and will last for years thereafter.

The acquisition of 71% interest of Signature Industry Limited, a manufacturer of sofa, was completed in January 2007. The acquisition will further enhance our products range in living room series and further ensure the supply and quality of sofa products. Sofa is a major piece of furniture in living room and has a higher rate of replacement than other furniture like bed frame and wardrobe. Chitaly will introduce international management standard such as corporate governance and professional cash flow management to the sofa factory and operate it in a professional manner.

The Group will continue to maintain its leading position in China furniture market by further strengthening its brand reputation through the Group's marketing strategies, superior design capabilities, high brand reputation, quality products and extensive distribution network. With a strong and solid fundamental, the Group aims at grabbing all profitable business opportunities in order to maximize the return of every cents of its equity. We are confident in 2007 and we are working to lift the barrier of entry in the China furniture market.

LIQUIDITY AND FINANCIAL RESOURCES

The Group maintained a cash and bank balances of HK\$63 million as at 31 December 2006 (2005: HK\$119.3 million). The Group is principally financed by net cash inflow from operating activities. The Group believes that funds generated from its internal operations are adequate to meet the future requirements of operating its business.

As at 31 December 2006, except for an interest-bearing bank loan amounting to HK\$11.7 million, the Group had no other bank borrowings and contingent liabilities. As at the same date, the gearing ratio was 0.59 (2005: 0.57).

As at 31 December 2006, approximately 75% of the Group's cash was dominated in Renminbi and 18% of the Group's cash was dominated in Hong Kong Dollars. The exposure to exchange fluctuation was minimal.

As at 31 December 2006, the liquidity of the Group as evidenced by the current ratio (current assets/current liabilities) was 1.23 times (2005: 1.66) and the net current assets was HK\$48,007,000 (2005: HK\$118,251,000).